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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact: _____, ID No. _____

Telephone Number:

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PLR-107595-06

Date:
October 24, 2006

Trust	=
Date 1	=
Decedent	=
Spouse	=
Date 2	=
State	=
Daughter 1	=
Daughter 2	=
<u>a</u>	=
Accountant	=
Date 3	=
<u>b</u>	=
<u>c</u>	=
Law Firm	=

Drafting Attorney =
State Court =

State Statute 1 =

State Statute 2 =

Cite 1 =

Cite 2 =

Cite 3 =

d =

Dear :

This responds to your representative's letter dated January 30, 2006, requesting rulings on the income, gift, and generation-skipping transfer (GST) tax consequences of the proposed reformation of Trust and division of a subtrust.

FACTS

The facts and representations submitted are summarized as follows. On Date 1, Decedent and Spouse created Trust, a revocable trust. On Date 2, Decedent died, a resident of State, whereupon Trust became irrevocable. Decedent was survived by Spouse, Daughter 1, Daughter 2, and grandchildren. Pursuant to Article 9 of Trust, Spouse is currently serving as the sole trustee of Trust.

Article 3 of Trust provides that after the death of the predeceased spouse, the trustee shall divide the trust estate into three trusts: the Survivor's Trust, to consist of one-half the community property and all of the separate property of the surviving spouse; the Marital Trust, to consist of the smallest amount necessary to reduce to zero the federal estate tax payable as a result of the death of the predeceased spouse; and, the Exemption Trust, to consist of the balance of the trust estate.

Article 3, Section 5 of Trust contains the provisions of the Marital Trust. Subsections (b) and (c) of Article 3, Section 5 of Trust provide for distributions of income and principal to the surviving spouse during her lifetime. Subsection (d) of Article 3, Section 5 of Trust provides with respect to the marital trust estate that on the death of the surviving spouse:

- (1) The trustees shall hold in trust the sum of \$a for each of the trustors' then living grandchildren. So long as a grandchild is under age thirty (30) years, the trustees shall pay to or apply for the benefit of said grandchild as much of the net income and principal of the trust as the trustees in the trustees' discretion deem necessary for his or her proper support, care, maintenance, and education. When a grandchild reaches the age of thirty

(30) years, the trustees shall distribute the grandchild's remaining trust estate, free of trust.

- (2) The trustees shall distribute the balance of the trust estate to the trustors' children, Daughter 1 and Daughter 2, share and share alike or to the survivor of them; provided that if any of said children do not survive distribution of the trust and leave living issue, the share of the predeceased child shall go to his or her issue by right of representation. However, if a part of that balance would otherwise be distributed to a person for whose benefit a trust is then being administered under this instrument, that part shall instead be added to that trust.

Article 3, Section 5, Subsection (e) of Trust provides for the distribution of the marital trust estate in the event the trustors and all of their issue are deceased before full distribution of the trust estate.

Article 3, Section 6 of Trust contains the provisions of the Exemption Trust. Subsections (b) and (c) of Article 3, Section 6 of Trust provide for distributions of income and principal to the surviving spouse during her lifetime. Upon the death of the surviving spouse, Subsection (d) of Article 3, Section 6 of Trust incorporates by reference Subsections (d) and (e) of Article 3, Section 5 of Trust.

Article 5 of Trust provides that if any beneficiary to whom the trustees are directed to distribute any share of trust principal is under the age of thirty (30) years when the distribution is to be made, his or her share shall vest in interest in him or her indefeasibly, but the trustees shall continue to hold it as a separate trust until the beneficiary reaches that age. In the meantime, the trustees shall use for the beneficiary's benefit so much of the income and principal as the trustees determine to be required in addition to his or her other income from all sources known to the trustees for his or her reasonable health, support, comfort, and education and adding any excess income to principal at the discretion of the trustees.

Spouse hired Accountant, a qualified tax professional, to prepare on behalf of Decedent's estate the United States Estate (and Generation-skipping Transfer) Tax Form (Form 706). It is represented that all of Decedent's GST tax exemption was available for allocation at his death. Form 706 was timely filed (with extensions) on Date 3. An election was made on Schedule M of the Form 706 to treat the property of the Marital Trust as qualified terminal interest property (QTIP) under § 2056(b)(7) of the Internal Revenue Code. Form 706 reflects that the Marital Trust was funded with a total of \$b in assets and the Exemption Trust was funded with a total of \$c in assets.

It is represented that in preparing the return, Accountant failed to allocate any of Decedent's GST tax exemption amount. Accountant further failed to advise Spouse how to fully utilize Decedent's GST tax exemption by severing the Marital Trust into a

GST exempt marital trust and a GST nonexempt marital trust and by making a reverse QTIP election under § 2652(a)(3) with respect to the assets of the GST exempt marital trust.

Subsequently, Spouse retained Law Firm to provide personal estate tax planning. Law Firm discovered that the Marital Trust had not been divided into a GST exempt and GST nonexempt marital trust and discovered that a reverse QTIP election under § 2652(a)(3) had not been made with respect to the assets of the severed GST exempt marital trust. Law Firm also identified problems or concerns with regard to several provisions in the trust instrument, as follows.

Spouse represents that Decedent and Spouse intended that upon the death of the surviving spouse, each then living grandchild receive \$a out of the assets of the first spouse to die. However, as drafted, Article 3, Section 5, Subsection (d) of Trust provides that upon the death of the surviving spouse, the trustee shall make a distribution of \$a out of the assets of the Marital Trust in trust to each then living grandchild, and Article 3, Section 6, Subsection (d) of Trust incorporates by reference this provision with respect to the assets of the Exemption Trust. The incorporation by reference suggests a second distribution of \$a is intended to a trust for each grandchild living on the death of the surviving spouse. In an affidavit, Drafting Attorney states that the terms of Trust did not express the trustors' intentions with regard to the amount of the distribution to the grandchildren's trusts.

Second, Spouse represents that it was the intention of Decedent and Spouse that if a grandchild were to die after a trust was established for that grandchild, but before that grandchild attained the age of 30, that any assets remaining in that grandchild's trust be distributed to that grandchild's estate. Because Article 5 of Trust is not expressly applicable to these trusts, it is not clear whether any assets remaining in that trust are to be distributed to that grandchild's estate, as intended by Spouse and Decedent.

Spouse/Trustee has brought an action in State Court, pursuant to State Statute 1, to sever the Marital Trust into the GST Exempt Marital Trust and the GST Nonexempt Marital Trust and, pursuant to State Statute 2, to reform Trust to resolve the above-described scrivener's error and ambiguity.

It is represented that, upon severance, the GST Exempt Marital Trust and the GST Nonexempt Marital Trust will be governed in accordance with the provisions governing the Marital Trust, as reformed. It is further represented that in funding the Exempt Marital Trust and the Nonexempt Marital Trust, the trustee may, in the trustee's discretion, make the division and distribution in cash, in kind, or partly in both, pro rata or non-pro rata, provided that any non-pro rata division and distribution of the Marital Trust assets shall be fairly representative of the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding.

To remedy the aforementioned scrivener's error, Spouse/Trustee is requesting that the court clarify Article 3, Sections 5 and 6, Subsections (d) of the Trust, to provide that upon the death of the surviving spouse, the trustee shall make a single distribution of \$a to each trust established for each living grandchild. The distributions to each of the trusts are to be made from the assets of the GST Exempt Marital Trust, the GST Nonexempt Marital Trust, and the Exemption Trust. The distribution of \$a is to be made pro rata from these trusts, based upon the value of each trust's assets on the date of death of the first spouse to die. In addition, Spouse/Trustee is requesting that the court clarify that if a grandchild of the trustors' dies before becoming entitled to receive distribution of his or her entire trust, the trustees shall distribute any remaining assets of such trust to that grandchild's estate.

State Court has determined that dividing the Marital Trust will have no impact on the beneficiaries' interests in the Marital Trust and will not impair the purpose of the Marital Trust. State Court has further determined that trustors intended (i) to make a single gift of \$a in trust to each grandchild living on the death of the surviving spouse out of the assets of the first spouse to die and (ii) to provide for the distribution of the assets of a grandchild's trust to the estate of that grandchild if the grandchild dies before receiving full distribution of his or her trust. Accordingly, State Court has granted Spouse/Trustee's petition to sever the Marital Trust and to reform Trust as requested, conditioned on receiving a favorable ruling on the income, gift, and generation-skipping transfer tax issues from the Service.

You have requested the following rulings:

1. Decedent's estate is granted an extension of time under § 301.9100-3 of the Procedure and Administration Regulations to sever the Marital Trust into the GST Exempt Marital Trust and the GST Nonexempt Marital Trust pursuant to § 26.2654-1(b)(1) of the Generation-Skipping Transfer Tax Regulations, and to make a reverse QTIP election under § 2652(a)(3) of the Internal Revenue Code for the GST Exempt Marital Trust.
2. The proposed construction and reformation of Trust will not alter the inclusion ratio of the Exemption Trust or the resulting GST Exempt Marital Trust under § 2642.
3. The proposed severance of the Marital Trust and the proposed construction and reformation of the Marital Trust and the Exemption Trust will not result in a transfer subject to gift tax under § 2501.
4. The proposed severance of the Marital Trust and the proposed construction and reformation of the Marital Trust and the Exemption Trust will not result in a recognition of gain or loss from a sale or other disposition of property under § 61.

Ruling Requests 1, 2, and 3

Section 2001(a) of the Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(1) provides, in pertinent part, that no deduction shall be allowed under § 2056(a) where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail.

Section 2056(b)(7)(A) provides that, in the case of qualified terminable interest property, the entire property shall be treated as passing to the surviving spouse for purposes of § 2056(a), and no part of such property shall be treated as passing to any person other than the surviving spouse for purposes of § 2056(b)(1)(A).

Section 2056(b)(7)(B)(i) defines the term "qualified terminable interest property" as property: (I) which passes from the decedent; (II) in which the surviving spouse has a qualifying income interest for life; and (III) to which an election under § 2056(b)(7) applies.

Section 2056(b)(7)(B)(v) provides that an election under § 2056(b)(7) with respect to any property shall be made by the executor on the return of tax imposed by § 2001, and that such an election, once made, shall be irrevocable.

Section 2044 provides, in relevant part, that the value of the gross estate shall include the value of any property in which the decedent had a qualifying income interest for life and for which a deduction was allowed under § 2056(b)(7).

Section 2044(c) provides that for purposes of chapter 11 and chapter 13, property includible in the gross estate of the decedent under § 2044(a) shall be treated as property passing from the decedent.

Section 2501 imposes a tax on the transfer of property by gift by an individual.

Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2601 imposes a tax on every GST. Under § 1433(a) of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i)

of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to any GST from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

Section 2611(a) provides that the term "generation-skipping transfer" means: (1) a taxable distribution; (2) a taxable termination; and (3) a direct skip.

Section 2602 provides that the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate.

Section 2641(a) defines the term "applicable rate" with respect to any GST as the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Section 2642(a)(1) provides that, generally, the inclusion ratio with respect to any property transferred in a GST is the excess of 1 over the "applicable fraction." With respect to a GST that is not a direct skip, § 2642(a)(2) provides that, in general, the applicable fraction is a fraction the numerator of which is the amount of the GST exemption under § 2631 allocated to the trust and the denominator of which is the value of the property transferred to the trust.

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 (adjusted for inflation under § 2631(c)) that may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Section 2632(a)(1) provides that any allocation by an individual of his or her GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2632(c)(1) (redesignated as § 2632(e)(1) by P.L. 107-16, § 561(a)) provides that, in general, any portion of an individual's GST exemption that has not been allocated within the time prescribed by § 2632(a) shall be deemed to be allocated as follows: (A) first, to property that is the subject of a direct skip occurring at such individual's death; and (B) second, to trusts with respect to which such individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual's death.

Section 26.2632-1(d)(2) provides that a decedent's unused GST exemption is automatically allocated on the due date for filing the Form 706, or Form 706NA, to the extent not otherwise allocated by the decedent's executor on or before that date. Unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)), on

the basis of the value of the property as finally determined for purposes of chapter 11 (chapter 11 value), first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)) on the basis of the chapter 11 value of the nonexempt portion of the trust property to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. No automatic allocation of GST exemption is made to a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust.

Section 2652(a)(1) provides that for purposes of chapter 13 the term "transferor" means: (A) in the case of any property subject to the tax imposed by chapter 11, the decedent; and (B) in the case of any property subject to the tax imposed by chapter 12, the donor. An individual shall be treated as transferring any property with respect to which such individual is the transferor.

Section 2652(a)(3) provides, in pertinent part, that in the case of any trust with respect to which a deduction is allowed to the decedent under § 2056 by reason of subsection (b)(7) thereof, the estate of the decedent may elect to treat all of the property in such trust for GST purposes as if the election to be treated as qualified terminable interest property had not been made. This election is referred to as a "reverse" QTIP election, and, as provided in § 26.2652-2(b), is made on the return on which the QTIP election was made.

Section 26.2652-2(a) provides, in part, that a reverse QTIP election is not effective unless it is made with respect to all of the property in the trust to which the QTIP election applies.

Section 2642(a)(3)(A) provides that if a trust is severed in a qualified severance, the trusts resulting from the severance shall be treated as separate trusts thereafter for GST purposes.

Section 2642(a)(3)(B)(i) defines "qualified severance" as the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if: (I) the single trust was divided on a fractional basis; and (II) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Section 2642(a)(3)(B)(ii) provides that if a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In this case, the trust receiving the fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1.

Section 2642(a)(3)(B)(ii) provides that the term "qualified severance" includes any other severance permitted under regulations prescribed by the Secretary.

Section 2642(a)(3)(C) provides that a severance provided for in § 2642(a)(3) may be made at any time.

Section 26.2654-1(b)(1)(ii) provides that the severance of a trust that is included in the transferor's gross estate into two or more trusts is recognized for purposes of chapter 13 if the governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and

- (A) The terms of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust; and
- (B) The severance occurs prior to the date prescribed for filing the federal estate tax return (including extensions actually granted) for the estate of the transferor; and
- (C) Either (1) the new trusts are severed on a fractional basis or (2) if the severance is required (by the terms of the governing instrument) to be made on the basis of a pecuniary amount, the pecuniary payment is satisfied in a manner that would meet the requirements of § 26.2654-1(a)(1)(ii) if it were paid to an individual. If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a non pro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding.

Section 26.2654-1(b)(2) provides that if a court order severing the trust has not been issued at the time the federal estate tax return is filed, the executor must indicate on a statement attached to the return that a proceeding has been commenced to sever the trust and describe the manner in which the trust is proposed to be severed. A copy of the petition or other instrument used to commence the proceeding must also be attached to the return. If the governing instrument of a trust or local law authorizes the severance of the trust, a severance pursuant to that authorization is treated as meeting the requirements of § 26.2654-1(b)(1)(ii)(B) if the executor indicates on the federal estate tax return that separate trusts will be created (or funded) and clearly sets forth the manner in which the trust is to be severed and the separate trusts funded.

Under § 301.9100-1(c) of the Procedure and Administration regulations, the Commissioner may grant a reasonable extension of time under the rules set forth in §§ 301.9100-2 and 301.9100-3 to make a regulatory election, or a statutory election (but no more than 6 months except in the case of a taxpayer who is abroad), under all subtitles of the Code except subtitles E, G, H, and I.

Section 301.9100-2 provides an automatic extension of time for making certain elections.

Section 301.9100-3(a) provides, in pertinent part, that requests for extensions of time for regulatory elections that do not meet the requirements of § 301.9100-2 must be made under the rules of § 301.9100-3. Requests for relief subject to § 301.9100-3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

Section 301.9100-3(b)(1) provides, in part, except as provided in § 301.9100-3(b)(3)(i) through (iii), a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

Section 301.9100-3(c)(1) provides, in pertinent part, that the Commissioner will grant a reasonable extension of time to make a regulatory election only when the interests of the Government will not be prejudiced by the granting of relief.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement or trustee action with respect to a trust that is exempt from the GST tax by reason of § 1433(b)(2)(A) of the Act will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13 if (1) the judicial action involves a bona fide issue, and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

Section 26.2601-1(b)(4)(E), Example 3, provides as follows. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their

issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law, as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13.

State Statute 1 provides, in relevant part, that "[o]n petition by a trustee or beneficiary, the court, for good cause shown, may divide a trust into two or more separate trusts, if the court determines that dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries."

State Statute 2 provides that a trustee or beneficiary may petition the court to determine questions of construction of a trust instrument. Under applicable state law, when construction of a trust instrument is under consideration, it is the court's proper function to give effect to the intention of the settlor. See Cite 1. To ascertain the settlor's intent, the State courts look to the trust instrument as a whole and the circumstances known to the settlor on execution. Cite 1 quoting Cite 2. In addition, the courts have accepted extrinsic evidence, such as an attorney's affidavit, that demonstrates that there has been a mistake. Cite 3.

With respect to Ruling Request 1, it has been represented that all of Decedent's GST tax exemption was available for allocation at his death. Although no allocations of Decedent's GST exemption were made on the estate tax return as filed, pursuant to § 2632(c) (redesignated as § 2632(e) by P.L. 107-16, § 561(a)), \$c of Decedent's GST exemption was automatically allocated to the Exemption Trust, leaving \$d of Decedent's GST exemption unused.

As a result of the QTIP election made on the Decedent's Form 706, the property of the Marital Trust is includible in Spouse's gross estate pursuant to § 2044. Spouse, accordingly, will be considered the transferor of the Marital Trust's assets for GST tax purposes. Therefore, Decedent's remaining GST exemption may not be allocated to the assets of the Marital Trust. However, if (1) the Marital Trust is severed into two trusts, the GST Exempt Marital Trust and the GST Nonexempt Marital Trust (as permitted by State Statute 1), and (2) a reverse QTIP election under § 2652(a)(3) is made with respect to the GST Exempt Marital Trust, Decedent will be treated as the transferor of the GST Exempt Marital Trust's assets. Under the automatic allocation rules in § 2632(c) (redesignated as § 2632(e) by P.L. 107-16, § 561(a)), Decedent's remaining

GST tax exemption of \$d will be allocated to the GST Exempt Marital Trust.

Based on the facts submitted and the representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. Accordingly, the estate is granted 60 days from the date of this letter to sever the Marital Trust into a GST exempt marital trust and a GST nonexempt marital trust and to file a supplemental Form 706 making the reverse QTIP election with respect to the GST exempt marital trust.

The Form 706 should be filed with the Internal Revenue Service Center, Cincinnati, Ohio 45999. A copy of this letter should be attached to the form.

With respect to Ruling Requests 2 and 3, Spouse, as the sole living trustor of Trust, and Drafting Attorney, the drafter of Trust, have presented affidavits in support of the claim that Trust as drafted contains certain scrivener's errors and ambiguities. State Court has determined that Trust, as drafted, does not comport with the intent of the trustors and has granted Spouse/Trustee's petition to reform the trust.

After examining the relevant trust instrument and representations of the parties, we have determined that Decedent and Spouse intended to make a single gift of \$a in trust for each grandchild living on the death of the surviving spouse out of the assets of the first spouse to die. Spouse/Trustee proposes to reform the Trust to effectuate the intent of the trustors by providing for a single distribution of \$a in trust for each then living grandchild, distributed pro rata out of the assets of the GST Exempt Marital Trust, the GST Nonexempt Marital Trust, and the Exemption Trust. We have additionally determined that Decedent and Spouse intended to provide for the distribution of the assets of a grandchild's trust to the estate of that grandchild if the grandchild died before receiving full distribution of his or her trust. Spouse/Trustee proposes to reform Article 3 of Trust to include such a provision.

Therefore, we conclude that the proposed reformation of Trust resolves bona fide issues regarding the proper understanding of the instrument and is consistent with applicable state law, as it would be interpreted by the highest court of State. We further conclude that reformation of Trust, as outlined above, will clarify the interests of the trust beneficiaries rather than create new interests. Based on the facts presented and the representations made, we conclude that the construction and reformation of Trust, as outlined above: (1) will not alter the inclusion ratio of the Exemption Trust or the resulting GST Exempt Marital Trust under § 2642, and (2) will not create a transfer of property that is subject to federal gift tax under § 2501.

Ruling Request 4

Section 61(a)(3) provides that gross income means all income from whatever source derived, including gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under § 1001(a). See § 1.1001-1.

In Rev. Rul. 69-486, 1969-2 C.B. 159, a non pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not convey authority to the trustee to make a non pro rata distribution of property in kind. The distribution was effected as a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries, an exchange that required recognition of gain under § 1001.

The division and severance of the Marital Trust in the present case is distinguishable from the non pro rata distribution in Rev. Rul. 69-486 because the assets of the Marital Trust will be distributed on a fractional basis to the GST Exempt Marital Trust and the GST Nonexempt Marital Trust pursuant to State law. Each beneficiary will continue to have the same share of each asset of the GST Exempt Marital Trust and the GST Nonexempt Marital Trust after the severance as each had before the severance. Accordingly, the severance of the Marital Trust will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries.

In the present case, Spouse/Trustee represents that Trust, as drafted, contains drafting errors and does not effectuate the original intent of Trustors (i) to make a single gift of \$a in trust for each grandchild living on the death of the surviving spouse out of the assets of the first spouse to die and (ii) to provide for the distribution of the assets of a grandchild's trust to the estate of that grandchild if the grandchild dies before receiving full distribution of his or her trust. Spouse, the sole surviving trustor, and Drafting Attorney have presented affidavits in support of the reformation of Trust. The proposed reformation of Trust is supported by State case law and is in accordance with State Statute 2. Therefore, we have determined that the proposed reformation of Trust is a clarification of the trustors' original intention. The beneficiaries will not acquire different

legal entitlements or exchange interests; rather, the proposed reformation is a clarification of the beneficiaries' original legal entitlements. Accordingly, we conclude that the reformation of Trust, as outlined above, will not constitute a taxable disposition for purposes of § 1001. Hence, no gain or loss will be realized by Trust or its beneficiaries under §§ 61 or 1001 as a result of the reformation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

William P. O'Shea
Acting Associate Chief Counsel
(Passthroughs & Special Industries)